HUTCHINSON
CAPITAL
MANAGEMENT

July 2012

INVESTMENT PERSPECTIVES

A Rational Approach to Risk

Management of investment risk requires a disciplined and thoughtful approach. It is very important to understand how to invest wisely in order to avoid the possibility of significant loss of capital.

In this Investment Perspective we will present some core principles regarding risk management that, we believe, must be incorporated in considering all financial decisions. These include risk versus volatility, price versus value, and risk mitigation strategies.

Difference between Volatility and Risk

Many investors on Wall Street define risk as the volatility in the price of a security. In this context, volatility is the up or down movement in the price of a stock over time. Wall Street likes to emphasize price volatility because they are generally more concerned with measurement instead of meaning when they consider the riskiness of a particular security. To satisfy their primary objective of quantifying risk, Wall Street calculates the historical market price movement of a security relative to the market as a whole and then reduces this historical price volatility into one single measure of risk.[1] The result is that securities with more historical price volatility relative to the market are considered to be more risky and those securities with less historical price volatility relative to the market are considered to be less risky. Importantly, Wall Street assumes implicitly that historical price volatility will be a good predictor of risk (future price volatility), irrespective of the security's underlying business fundamentals.

At Hutchinson Capital Management, we view risk as the likelihood of losing your capital rather than the change in the price of an individual stock versus the general stock market. Accordingly, we consider both the likelihood and magnitude of a loss by carefully studying the underlying business fundamentals and intrinsic stock value when we invest capital in specific securities. Unlike Wall Street investors, we don't believe that a single measure (beta) reflecting historical market price movement encapsulates the overall riskiness of a security. Historical price movements do not predict future price movements reliably, which implies that historical

[1] The single measure discussed here is beta. Beta compares a security's or portfolio's historical price fluctuations with those of the market as a whole. High-beta stocks are deemed to be riskier than low-beta stocks, because they exhibit greater price volatility.

price volatility is an inadequate measure of risk. As renowned value investor Seth Klarman reminds us, "investments do not provide information about their risks the way food packages provide nutritional data."[2]

Price vs. Value

Among Warren Buffet's many sayings is the following: "Price is what you pay, value is what you get." In investing, there is a tremendous difference between price and value. Many people believe that the price of the stock tells you all you need to know. When the stock price declines, they assume that the stock is a poor investment, that there has been negative news, and that the company cannot resolve its problems. But in many instances, just the opposite is true – it may be just the right time to step in and buy the stock.

Alternatively, many investors believe that if the price is going up, it must be a great stock and a good time to buy. This type of investing is grounded in the belief that the market is always right. We believe investing in this way will lead to underperformance due to the risks of buying high and selling low.

As value investors, we believe that it is far more important to focus on ascertaining the value or the true worth of a company rather than the price of the stock *today*. This value is driven by its future cash flows and demand for its products and services. Perceptions can drive huge differences between price and value.

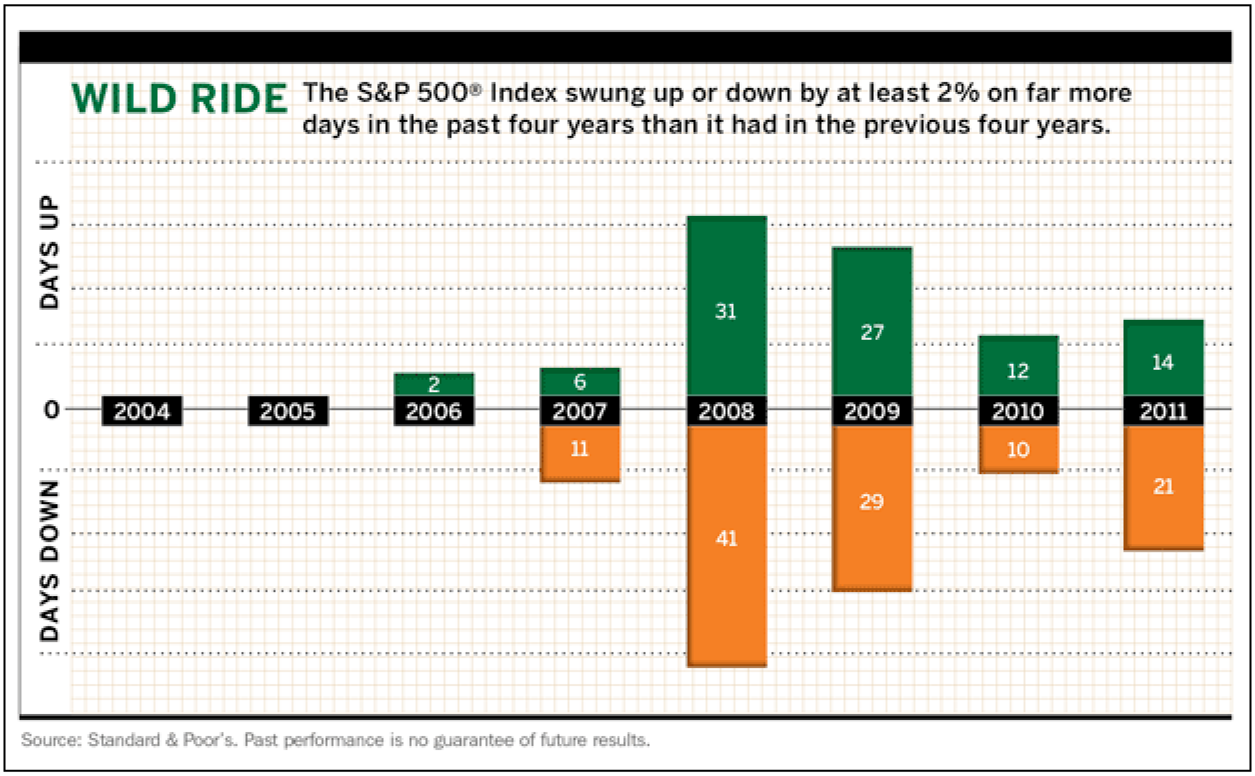
As an example, think of owning a rental building in San Francisco. You are in a great location with great tenants in a growing metropolitan city. A few of your neighbors who own their buildings mismanage their finances and fall into bankruptcy and thus have to sell their buildings at drastically reduced prices. A buyer of buildings comes to you and relays these findings and tells you your building is worth 40% less than your perceived value due to these bankruptcies nearby. Would you sell? Most people would laugh and say "of course not" as they know these decreases are temporary. The interesting thing is that in the stock market many people do sell and take the reduced price as the true value of the underlying business. By focusing on fundamentals instead of prices, we aren't moved by day-to-day "noise" in the companies we own.

As value investors we believe that we have an advantage over price focused investors – we have time and patience on our side. If the market doesn't want to give us a good price, we can wait for the "fat pitch" before deciding to swing at the ball. Also, we can sell when price focused investors become enamored with a stock and extrapolate great returns for many years. In the end, we are empowered to take advantage of the market and not be controlled by its swings.

[2] Klarman, Seth. Margin of Safety.

Risk Management Strategies

The bar chart below illustrates how stock prices have fluctuated dramatically over the past few years, especially when compared to the four years leading up to the economic and market downturn in 2008:



This turbulence has contributed to heightened concerns among investors about risk in general and in many cases has led to emotional reactions, rather than rational responses, in investment decision-making. Regardless of the specific market conditions at any particular point in time, we place heavy importance on risk management throughout each phase of our investment decision-making process. While risk cannot be eliminated entirely it can be mitigated. The following are a few strategies that we have found effective in helping counteract risk.

Diversification: Diversification is one method of reducing risk in an investment portfolio. For us, diversification translates into determining an appropriate asset allocation between the asset classes of high quality stocks, bonds and cash instruments. In our experience this exercise is more art than science in practice, contrary to what is purported in mainstream finance academic literature. It is simply human nature to extrapolate recent trends and this tendency can lead to overweighting asset classes that have worked in the recent past. Examples include widespread enthusiasm for stocks in the late 1990s and, more recently, the preference to favor bonds as evidenced by sizable inflows into bond mutual funds.

Investments in stocks provides the potential for capital appreciation, acts as a hedge against inflation, and generates current income (assuming dividends are paid out). Investments in individual high-quality bonds generates current income and stability of principal (assuming the bonds are held to maturity). Importantly, since the price of stocks and bonds typically do not move in tandem, diversifying a portfolio by having exposure to both asset classes can be effective in helping protect against downside risk. Arriving at an appropriate asset mix requires careful planning and analysis, and a thorough understanding of individual circumstances including goals, objectives, return expectations, risk tolerance, and cash needs.

Value: Experience has taught us that sustaining attractive long-term investment returns is predicated as much, if not more, on avoiding significant losses rather than selecting big winners. As such, in our research efforts we play the role of "paid skeptics" by challenging the underlying assumptions of Wall Street analysts and company management, which frequently can be very optimistic. In order to mitigate downside risk, we ensure that we are comfortable with an investment at its current price should a scenario develop that we did not anticipate.

As discussed previously, we define risk as the likelihood of losing your capital. Our intent is to minimize the chance of losing capital by having the discipline to purchase a stock only at a price below our assessment of the underlying worth of the company, its intrinsic value. If we do our homework properly, we will buy stock in a company at a fair price with significant potential for capital appreciation. Accordingly, we focus on high quality, "best in class" companies but only those that are trading at bargain prices. Legendary investor Sir John Templeton had the following to say on this topic: "There is only one reason a stock is being offered at a bargain price: because other people are selling. There is no other reason. To get a bargain price you have to look where the public is most frightened and pessimistic."

Long-Term Focus: We believe that attempting to guess the direction of short-term price movements is unproductive and unrelated to mitigating risk. Nonetheless, instant information and high frequency trading have become dominant traits in today's market behavior. It is a telling statistic that the average holding period for stocks traded on the New York Stock Exchange is only four months.[3] By contrast, we focus our research efforts on the long-term financial and operating metrics of a company. We constantly remind ourselves that the shares of the companies we invest in represent ownership stakes in real businesses. Because we invest with a 3-5 year time horizon we attempt to look beyond the "noise" of short-term price movements and forecasts.

Conclusion: Volatility equals Opportunity

We believe that focusing on the fundamental value rather than statistical short-term information when selecting investments is the preferred way to invest our clients' capital. In doing so, we expect to achieve a fair return on our investments while striving to ensure that our clients' principal is preserved. We will continue to research those stocks whose price is below its intrinsic value and we will continue to avoid the "noise" in the stock market by focusing on long term results. We believe that selecting stocks at the right price while mitigating risk and ignoring volatility will provide our clients with reasonable returns and preserve their capital.

[3] The Economist (August 6, 2011) "Not So Fast, The Risks Posed by High Frequency Trading"

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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